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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. 602

GALEN H. WELCH, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE SIXTH COLLECTION DISTRICT OF CALIFORNIA, PETITIONER

v.

OBISPO OIL COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The first opinion of the District Court of the United States for the Southern District of California is reported in 48 F. (2d) 872; the second (R. 12–23) is not reported. The majority and dissenting opinions in the Circuit Court of Appeals (R. 35–40) are reported in 85 F. (2d) 860.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 28, 1936 (R. 40). The petition for certiorari was filed December 28, 1936, and was granted February 8, 1937. The jurisdic-

tion of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

After the Commissioner of Internal Revenue has granted a special assessment of profits taxes, pursuant to Sections 327 and 328 of the Revenue Act of 1918, may a court, in an action for refund of income taxes, revise the Commissioner's determination of the taxpayer's net income?

STATUTE INVOLVED

The statute involved will be found in the Appendix, *infra*, pp. 12–14.

STATEMENT

The District Court made special findings of fact (R. 12–21). Those pertinent to the question here involved may be summarized as follows:

Pursuant to Sections 327 and 328 of the Revenue Act of 1918, the Commissioner of Internal Revenue determined the profits taxes of the taxpayer for the calendar year 1920 to be $142,765.73, or 9.67% of its net income (R. 21). The taxpayer's income tax for the same year was determined by the Commissioner as follows (R. 21):

Net income		$1,476,330.52
Less:		
Profits tax, Section 328	$142,765.73	
Interest on U. S. obligations not exempt	86,134.16	
Exemption	2,000.00	
		230,899.89
Balance subject to 10% tax		1,245,430.63
Amount of tax at 10%		124,543.06

Thereafter, on December 6, 1927, the taxpayer filed a claim for refund, setting up several grounds for recovery. (R. 18–19.) The claim was rejected on or about February 14, 1928, and the taxpayer filed its original complaint in the District Court on December 2, 1928. (R. 19.)

The District Court found that the Commissioner had overstated the net income by $40,102.44, determined as follows (R. 21–22):

Overstatement of two items: (1) $47,461.37 representing over-valuation of Liberty bonds turned over to the taxpayer by the Receiver in 1920; and (2) $159,751.56, representing proceeds from the sale of oil produced prior to March 11, 1914, together with interest during the years 1914 to 1919, inclusive, under certain agreements with the Standard Oil Company.

Understatement of two items: (1) $40,683, representing capital expenditures in connection with litigation which were erroneously allowed as deductions; and (2) $126,427.49, representing the depletion deduction allowed by the Commissioner on oil and gas produced prior to April 20, 1920.

The District Court concluded that it had jurisdiction of the subject matter of this action to the extent of determining the correct amount of income tax, even though the profits taxes of the taxpayer for the calendar year 1920 had been determined under the special assessment provisions of the 1918 Act. (R. 21.) The tax on the net income found

to be overstated was found to be $4,010.24, and the District Court entered judgment against petitioner accordingly. (R. 23.) On appeal, the Circuit Court of Appeals sustained the District Court.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the District Court had jurisdiction of the subject matter of this action to the extent of revising the taxpayer's net income after it had been determined by the Commissioner for the purpose of computing the profits taxes as provided in Sections 327 and 328 of the Revenue Act of 1918.

2. In entering judgment for the taxpayer.

SUMMARY OF ARGUMENT

The decisions of this Court have denied to the courts the power to substitute their discretion for the Commissioner's as to the factors to be used in computing the tax under Sections 327 and 328 of the Revenue Act of 1918. The courts below, however, revised one of those factors, the net income, not, it is true, for profits tax purposes but only for income tax purposes. It is submitted that a power to revise the net income for income tax purposes in such cases, if lodged in the courts, would directly affect the conclusion reached by the Commissioner in the determination of the profits taxes, necessitating a reexamination to determine whether the revision has removed the abnormality.

If it has not, a search for other representative corporations similarly circumstanced might be required, in which case a different profits tax rate would be applied to the new net income. The result would be to nullify the denial to the courts of the power to invade the discretionary field confided to the Commissioner. An application for special assessment under Section 327 (d) assumes adherence to the statute in the determination of both net income and invested capital and constitutes an abandonment of the right to have the tax computed in accordance with the normal method. Consequently, questions relating to the determination of net income are no longer justiciable.

ARGUMENT

The Revenue Act of 1918, which applies to the year 1920, the year here involved, imposed an excess profits tax at high rates. Because such a tax might, in particular circumstances, become unduly burdensome, Congress provided that in certain situations the tax should be computed in a special manner. This alternative method of assessment, which is provided for by Sections 327 and 328, *infra*, pp. 12, 13, is known as a special assessment.

Subdivision (d) of Section 327, which was here applied,[1] is dependent upon the request of the taxpayer. Pursuant to such a request by respondent,

[1] In its brief opposing the granting of a writ of certiorari respondent contended that the record did not reveal whether the special assessment was made pursuant to subsection (d) of Section 327, which requires an application

its profits tax was computed under the special assessment provisions because certain abnormal conditions had affected its income for that year (R. 4). Notwithstanding this fact, respondent now seeks in this proceeding to have the computation of its income—the factor upon which the special assessment was based—reviewed by the courts and adjudged to be less than the figure employed by the Commissioner in giving respondent the benefit of Sections 327 and 328.

This Court, in *Heiner* v. *Diamond Alkali Co.*, 288 U. S. 502, has decided that where a taxpayer's *profits taxes* have been settled by the Commissioner under Sections 327 and 328, a court may not revise that computation by a revision of the factors which entered into that computation. We submit that the same result should follow in a suit for refund of *income taxes*, particularly when the abnormality of the income is the very fact which caused the Commissioner to exercise his discretion under the special assessment provisions.

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by the taxpayer, or under subsection (a), (b) or (c), all of which are mandatory upon the Commissioner (Br. pp. 4–5). Respondent's amended complaint, however, alleges that Sections 327 and 328 were applied "due to the abnormality resulting from the inclusion in plaintiff's income for that year [1920] of said impounded funds" (R. 4). Further, respondent alleged that if the impounded funds were eliminated from its income for the year 1920, the application of Sections 327 and 328 would no longer be necessary (R. 5). Obviously, abnormal income is a condition warranting relief only under Section 327 (d), and it is that subdivision which must have been applied.

To deny to the courts the power to review the elements considered by the Commissioner in the determination of the profits taxes under the special assessment provisions but to permit, for purposes of the income tax, judicial revision of an indispensable and often controlling factor in the computation under the relief provisions would bring about a most incongruous situation. It would permit the use of one net income for income taxes under Title II and another net income for profits taxes under Title III, though Section 320 (a) (3) of the Revenue Act of 1918 provides for the same net income under both titles. Furthermore, it would seem to be a contradiction in terms to say that a determination to grant or deny extraordinary relief is not open to judicial review and yet to say that the factors entering into the determination of the tax under the relief provisions may be reviewed. *Cf. Williamsport Wire Rope Co.* v. *United States,* 277 U. S. 551. If considerations affecting net income are to remain open to review, the very basis upon which special assessment can be granted and made becomes a shifting one and the assessment an idle gesture, binding the Government possibly but never the taxpayer. *Cleveland Automobile Co.* v. *United States,* 70 F. (2d) 365 (C. C. A. 6th), certiorari denied, 293 U. S. 563.

The practical effect of the decision below is to give to the courts the power to revise or alter factors entering into the determination of the profits taxes under Sections 327 and 328, and place

upon the Commissioner the obligation to revise his computations under the relief provisions. In the instant case an abnormality affecting income was successfully urged as the ground for the exercise of the Commissioner's discretionary jurisdiction. The judicial revision of income may have removed the very abnormality which produced the asserted hardship and which persuaded the Commissioner to grant extraordinary relief. Certainly, a revised net income would require a reexamination of the comparatives used and possibly compel a search for representative concerns similarly circumstanced different from those previously used. See *Heiner* v. *Diamond Alkali Co., supra,* at p. 507. Necessarily the profits tax rate applicable to the new net income would be corrected. *Central Iron & Steel Co.* v. *United States,* 6 F. Supp. 115 (C. Cls.), certiorari denied, 293 U. S. 563; *W. H. Bradford & Co.* v. *United States,* 6 F. Supp. 117 (C. Cls.). It seems plain, in other words, that a denial of judicial review of the factors which enter into a computation under the relief sections for the purpose of the profits tax only would be no denial at all. Revision of net income by the courts would entail revision by the Commissioner of rates, comparatives and the profits tax itself. Any revision of the profits tax would in turn be reflected in the income tax, because the amount of the former is a credit against the latter under Section 236 (c). The duty to protect the revenues would require the

Commissioner to reopen the case and to reconsider his previous determination. Since the courts are precluded from themselves making these revisions and are equally without authority to remand cases to the Commissioner for his further consideration in the light of a new computation of income, judicially determined, it is clear that the whole matter of the taxpayer's income and profits taxes does not lend itself to judicial review after the taxpayer has, of its own motion, invoked the administrative alternative provided by the statute. *Central Iron & Steel Co.* v. *United States, supra,* at p. 116.

Once a taxpayer has applied for and been granted the extraordinary relief afforded by Sections 327 and 328, he has, by his own act, removed himself from judicial relief. *Michigan Iron & Land Co.* v. *United States,* 10 F. Supp. 563 (C. Cls.). He surrenders the right further to contest in court the correctness of the Commissioner's determination with respect to any of the factors necessary to his discretionary findings and the computation of the tax. *Central Iron & Steel Co.* v. *United States, supra; United States* v. *Henry Prentiss & Co.,* 288 U. S. 73.

In the *Prentiss* case, the Commissioner sent out the usual notice that unless the taxpayer acquiesced in the net income and invested capital no consideration would be given to the application for special assessment. The evidence does not disclose an ac-

quiescence, but this Court said (pp. 87–88) that the taxpayer's conduct in proceeding with its application for a special assessment "was a tacit assent to the condition imposed by the Commissioner and an abandonment of any objection that capital and income had been erroneously valued if valuation was to be ascertained according to the normal method". It is pointed out (288 U. S. at 88) that there is room for argument that the taxpayer, having won the privilege of a hearing on those terms, is estopped from retracting its assent and resuming the abandoned ground. That observation is particularly relevant here for at least two reasons. One is that not only did the taxpayer win the privilege of a hearing, but it actually received the benefits of a special assessment. The other is that retraction, if permitted, would enable it to retain such benefits while the Commissioner would be barred by the statute of limitation, if not by the principles of *res judicata*, from asserting a deficiency in tax which would obviously be due as a result of the changed net income. *Cf. Continental Products Co.* v. *Commissioner*, 66 F. (2d) 434 (C. C. A. 1st); *Newaygo Portland Cement Co.* v. *Helvering*, 77 F. (2d) 536 (App. D. C.).

The question here involved, though present in *United States* v. *Supplee-Biddle Hardware Co.*, 265 U. S. 189, was not submitted to the Court for decision. The case of *Welch* v. *St. Helens Petroleum Co.*, 78 F. (2d) 631 (C. C. A. 9th), is distinguishable. There the taxpayer was a foreign

corporation, and Section 327 (b) requires that the profits tax be determined as provided in Section 328. The ground for relief covered by Section 327 (d) is obviously not the same as the ground in Section 327 (b). Cf. *Bemis Bro. Bag Co.* v. *United States,* 289 U. S. 28. Under Section 327 (b) there could be no abandonment of one method for another, since but one method is provided for.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted,

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FEBRUARY, 1937.

APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057:

SEC. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

* * * * *

(c) In the case of a domestic corporation, $2,000.

SEC. 320. (a) That for the purpose of this title the net income of a corporation shall be ascertained and returned—

* * * * *

(3) For the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined

without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily

determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

* * * * *

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